In the Supreme Court of the United States

OCTOBER TERM, 1938

No. 509

DENIS J. DRISCOLL, THOMAS C. BUCHANAN, DONALD M. LIVINGSTON, RICHARD J. BEAMISH and JOHN SULLIVAN, Individually and Constituting PENNSYLVANIA PUBLIC UTILITY COMMISSION; and UTILITY CONSUMERS LEAGUE OF YORK, PA.,

Appellants,

v.

EDISON LIGHT & POWER COMPANY,

Appellee.

Appeal From the District Court of the United States for the Eastern District of Pennsylvania

BRIEF OF PENNSYLVANIA PUBLIC UTILITY COMMISSION

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CITATIONS

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OPINIONS BELOW

The order of Pennsylvania Public Utility Commission is reported in 17 Pennsylvania Public Utility Commission Reports 380, and in 21 Public Utility Reporter (New Series) 328. The opinion of the District Court for the Eastern District of Pennsylvania is reported in 25 Federal Supplement 192.

CONSTITUTIONAL PROVISION AND STATUTE INVOLVED

Article XIV, Section 1, of the Amendments to the Federal Constitution provides:

> "All persons born or naturalized in the United States, and subject to the jurisdiction thereof, are citizens of the United States and of the State wherein they reside. No State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; Nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws."

Section 310 of the Pennsylvania Public Utility Law (Act of May 28, 1937, Pamphlet Laws 1053, Purdon's Pennsylvania Statutes Annotated, 1938 Supplement, Title 66, Section 1150) provides (omitting paragraph (d) which is not here in issue):

> "Temporary Rates.—(a) The commission may, in any proceeding involving the rates of a public utility brought either upon its own motion or upon complaint, after reasonable notice and hearing, if it be of opinion that the public interest so requires, immediately fix, determine, and prescribe temporary rates to be charged by such public utility, pending the final determination of such rate proceeding. Such temporary rates, so fixed, determined, and prescribed, shall be sufficient to provide a return of not less than five per centum upon the original cost, less accrued depreciation, of the physical property (when first devoted to public use) of such public utility, used and useful

in the public service, and if the duly verified reports of such public utility to the commission do not show such original cost, less accrued depreciation, of such property, the commission may estimate such cost less depreciation and fix, determine, and prescribe rates as hereinbefore provided.

"(b) If any public utility does not have continuing property records, kept in the manner prescribed by the commission, under the provisions of section five hundred two of this act, then the commission, after reasonable notice and hearing, may establish temporary rates which shall be sufficient to provide a return of not less than an amount equal to the operating income for the year ending December thirty-first, one thousand nine hundred thirty-five, or such other subsequent year as the commission may deem proper, to be determined on the basis of data appearing in the annual report of such public utility to the commission for the year one thousand nine hundred thirty-five, or such other subsequent year as the commission may deem proper, plus or minus such return as the commission may prescribe from time to time upon such net changes of the physical property as are reported to and approved for rate-making purposes by the commission. In determining the net changes of the physical property, the commission may, in its discretion, deduct from gross additions to such physical property the amount charged to operating expenses for depreciation or, in lieu thereof, it may determine such net changes by deducting retirements from the gross additions: Provided, That the commission, in determining the basis for temporary rates, may make such adjustments in the annual report data

as may, in the judgment of the commission, be necessary and proper.

"(c) The commission may, in the manner hereinbefore set forth, fix, determine, and prescribe temporary rates every month, or at any other interval, if it be of opinion that the public interest so requires, and the existence of proceedings begun for the purpose of establishing final rates shall not prevent the commission from changing every month, or at any other interval, such temporary rates as it has previously fixed, determined, and prescribed.

"(d) * * *

"(e) Temporary rates so fixed, determined, and prescribed under this section shall be effective until the final determination of the rate proceeding, unless terminated sooner by the commission. In every proceeding in which temporary rates are fixed, determined, and prescribed under this section, the commission shall consider the effect of such rates in fixing, determining, and prescribing rates to be thereafter demanded or received by such public utility on final determination of the rate proceeding. If, upon final disposition of the issues involved in such proceeding, the rates as finally determined, are in excess of the rates prescribed in such temporary order, then such public utility shall be permitted to amortize and recover, by means of a temporary increase over and above the rates finally determined, such sum as shall represent the difference between the gross income obtained from the rates prescribed in such temporary order and the gross income which would have been obtained under the rates finally determined if applied during the period such temporary order was in effect."

STATEMENT OF THE CASE

Pennsylvania Public Utility Commission, one of the appellants, is the Commission of the Commonwealth of Pennsylvania duly authorized to exercise regulatory jurisdiction generally over public utilities. Appellee is Edison Light & Power Company, a public utility engaged solely in intrastate commerce, and rendering electric service to approximately 30,000 customers in the City of York and contiguous territory. Appellee has no funded debt, and all of its capital stock is owned by York Railways Company and is pledged as security for the funded debt of York Railways Company. The common stock of York Railways Company is wholly owned by NYPANJ, a holding company in the Associated Gas & Electric Company system.

On the 27th day of January, 1936, a Commission inquiry and investigation was instituted to determine the reasonableness of the rates of Edison Light & Power Company under the provisions of the then substantive regulatory law of the Commonwealth of Pennsylvania, Act of July 26, 1913, P. L. 1374. (Purdon's Pennsylvania Statutes Annotated, Title 66, Section 1, et seq.) Several hearings were held, at which testimony was presented. During the progress of this case, the utility law of the Commonwealth of Pennsylvania was recodified, the Act of 1913, P. L. 1374, was repealed and, in lieu thereof, the Legislature enacted the Public Utility Law, Act of May 28, 1937, P. L. 1053. (Purdon's Pennsylvania Statutes Annotated, 1938 Supplement, Title 66, Section 1101 et seq.)

Section 310 of the new Public Utility Law authorizes the Commission, during the pendency of a rate case, to prescribe temporary rates, the effect of which rates must be considered by the Commission in prescribing final rates at the termination of the general rate proceeding. On July 27, 1937, after notice of its intention to prescribe temporary rates, and after argument before it, the Commission issued a temporary rate order against Edison Light & Power Company. The order directed the company to revise its tariff to effect a reduction of its gross annual revenues in the sum of $435,000.

A bill in equity was filed by the company in the United States District Court for the Middle District of Pennsylvania. A temporary restraining order was issued by the Court. The cause was heard before a three-judge Court, as provided by Section 266 of the Judicial Code. Following the taking of testimony and argument, the Court, on October 15, 1937, permanently enjoined the order of the Commission. Each of the Judges who constituted the special Court wrote an opinion in the matter. Two of the judges, Judge Johnson and Judge Watson, held that the temporary rate provisions of the Public Utility Law did not offend constitutional limitations, but that the order of the Commission failed to indicate the bases or the findings upon which the Commission prescribed its rate reductions. The opinion of Judge Davis agreed that the Commission had insufficiently indicated the bases of its order, but further held that the temporary rate provisions, authorizing the fixing of rates based upon

the original cost of the property of the company, were unconstitutional since they failed to take cognizance of the standards prescribed by the Court in the case of **Smyth v. Ames,** 169 U. S. 466, and cases following that decision. The opinions aforesaid are reported in **Edison Light & Power Co. v. Driscoll,** 21 F. Supp. 1.

Following the decision of the Middle District Court, the Commission on November 30, 1937, issued a supplemental temporary rate order in which it reviewed the record, and set forth at length the bases for its findings. The company was again ordered to revise its tariffs to effect a reduction in the annual gross operating revenues in the sum of $435,000. The Commission order gave consideration to the reproduction cost evidence, to the original cost evidence, and to the other matters of record. The order referred to the fact that it involved merely temporary rates, and reserved doubtful points for consideration in a final order.

The Commission found that, for the purpose of fixing temporary rates, the value of the company property was $5,250,000. The order of the Commission indicates that it accepted almost entirely the operating expenses claimed by and experienced by the company, and allowed them for temporary rate purposes. The annual allowances for operating expenses, depreciation, and return of 6 per cent upon the aforestated value of $5,250,000 totaled $1,697,829. The actual experience of the company showed annual gross operating revenues of $2,202,329 for the 12-month period ending September 30, 1937, an excess of $504,500

over the revenues found allowable. The Commission, however, prescribed temporary rates to effect a reduction of only $435,000.

The company then filed a bill to enjoin the order of the Commission of November 30, 1937, aforesaid, in the United States District Court for the Eastern District of Pennsylvania. A three-judge Court was again constituted, under the provisions of Section 266 of the Judicial Code. A temporary injunction was issued. Testimony was taken and argument had before this three-judge Court for the Eastern District on January 17, 1938, and, on October 14, 1938, the preliminary injunction was made permanent. The opinion of the Court (25 F. Supp. 192) was written by Judge Davis, who, following the opinion he had rendered sitting in the Middle District, held that Section 310(a) of the Public Utility Law offended constitutional restrictions in that it failed to direct the Commission to consider the elements of fair value prescribed in **Smyth v. Ames**, and cases following that decision, and that the temporary rates would result in confiscation of the company property. It is from this order that this appeal has been taken.

SPECIFICATION OF ERRORS TO BE URGED

The United States District Court for the Eastern District of Pennsylvania erred:

1. In holding that Section 310 of the Pennsylvania Public Utility Law is unconstitutional as contravening the Fourteenth Amendment.

2. In holding that the findings and conclusions of the Pennsylvania Public Utility Commission Order of November 30, 1937, are not supported by substantial record evidence.

3. In holding that Pennsylvania Public Utility Commission, in computing temporary rates, improperly disallowed certain operating expenses claimed by appellee.

4. In holding that the temporary rates fixed by Pennsylvania Public Utility Commission were confiscatory,

5. In failing to dismiss the bill of complaint for want of equity, and in failing to dissolve the temporary restraining order theretofore entered.

6. In entering its final decree of October 14, 1938, permanently enjoining enforcement of the temporary rates prescribed by Pennsylvania Public Utility Commission on November 30, 1937, cancelling appellee's injunction bond and imposing all costs on Pennsylvania Public Utility Commission and its members.

SUMMARY OF ARGUMENT

I.

Temporary rates are desirable for effective rate regulation. Under such rates, consumers have the prompt benefit of reduced rates when warranted by the facts, and the Commission is provided with valuable experience data for use in determining proper final rates.

II.

Section 310 of the Pennsylvania Public Utility Law is constitutional. It provides an adequate method for recoupment of loss, if any, while temporary rates are in effect, and thereby prevents confiscation. Furthermore, the provisions of this section do not restrict the Commission as to the elements of value it may consider, and authorize the prescription of just and reasonable temporary rates consistent with constitutional standards.

III.

Rates that afford to a public utility a fair return upon the prudent original cost of its property used or useful in public service are not confiscatory. The reproduction cost doctrine hinders effective regulation. It is unsound from the engineering and accounting standpoints. The temporary rates here involved permit more than a compensable return on prudent original cost, and, therefore, do not violate the Federal Constitution.

IV.

The Commission findings as to rate base, operating expenses, depreciation, and rate of return, are reasonable and proper and supported by substantial evidence. As clearly appears from the Commission order and the record, the Commission received and considered in detail, evidence presented on behalf of the Commission and the utility on reproduction cost, original and book cost, working capital, going concern value, depreciation, operating expenses and rate of return. If reproduction cost must be considered on the issue of confiscation, the record in this case contains sufficient evidence, and the Commission order shows sufficient consideration thereof, to sustain the rates prescribed by the Commission.

V.

Upon all of the facts and the law, the injunction restraining the enforcement of the temporary rate order of the Commission should be dissolved.

ARGUMENT

I.

TEMPORARY RATES ARE DESIRABLE FOR EFFECTIVE RATE REGULATION

A.

Temporary Rates are Advantageous to the Consumers.

The power and duty to determine the reasonableness of rates charged by Pennsylvania public utilities has been vested in the Pennsylvania Public Utility Commission by the provisions of the Pennsylvania Public Utility Law.

The Pennsylvania Act, at Section 309, (Purdon's Pennsylvania Statutes Annotated, 1938 Supplement, Title 66, Section 1149), provides:

> "Whenever the commission, after reasonable notice and hearing, upon its own motion or upon complaint, finds that the existing rates of any public utility for any service are unjust, unreasonable, or in anywise in violation of any provision of law, the commission shall determine the just and reasonable rates (including maximum or minimum rates) to be thereafter observed and in force, and shall fix the same by order to be served upon the public utility, and such rates shall constitute the legal rates of the public utility until changed as provided in this act. * * *"

It is under the provisions of this section that the Commission is proceeding to determine the reasonableness of the rates of appellee. Before completion

of the process it became apparent from the record that, if the Commission were to restrict the company to a return of 6 per cent on its own fair value figure, its gross operating revenues were admittedly excessive. (R.804,805). This admitted excess, plus the elimination of obviously improper items from the rate base and from operating expenses, indicated to the Commission that an immediate reduction in gross operating revenues of at least $435,000 should be ordered.

Clearly, it is desirable for any regulatory Commission, under these circumstances, to have the power to prescribe reasonable temporary rates, pending further consideration of matters in substantial dispute.

Prior to the enactment of the Pennsylvania Public Utility Law, consumers were forced to pay excessive rates during the entire pendency of the rate proceeding, and until the time final reduced rates were prescribed by the Commission. Because of the lack of specific statutory power to fix reasonable temporary rates during the progress of the rate proceeding, the utilities, in many instances, have availed themselves of every conceivable pretext for delay.[1]

Rate proceedings against both small and large utilities have required extensive hearings, often spread over a period of years, sometimes as great as ten years. Such rate proceedings result in records monu-

[1] McCart v. Indianapolis Water Co., 302 U. S. 419, dissenting opinion Mr. Justice Black, p. 435; St. Joseph Stock Yards Co. v. United States, 298 U. S. 38, concurring opinion Mr. Justice Brandeis, pp. 88-93; Scranton-Spring Brook Water Service Co. v. P. S. C., 119 Pa. Superior Ct. 117; Pennsylvania Power & Light Co. v. P. S. C., 128 Pa. Superior Ct. 195.

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mental in size. Many of the problems raised by these proceedings have been intricate and involved; and much of the evidence produced has been conflicting opinion testimony varying in worth and presenting a maze of detail and figures: **City of Louisville v. Cumberland Tel. & Tel. Co.**, 225 U. S. 430. Yet, with this involved and uncertain evidence, there is frequently evidence that is definite, certain, and uncontradicted, upon which a rate reduction could be based, pending final consideration of the controversial issues. The inability of a regulatory commission to effect immediate rate reductions in cases in which such reductions were clearly warranted called for a remedy, and so it was that Section 310 of the Pennsylvania Public Utility Law was enacted to provide this remedy.

B.

Temporary Rates Provide Valuable Experience Data For Use in Determination of Proper Final Rates.

This Court has plainly indicated that whenever actual experience is available, it will be given first place in determining the reasonableness of rates.[2]

Under the provisions of Section 310 of the Public Utility Law, providing for reasonable temporary rates

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[2] West Ohio Gas Co. v. Public Utilities Commission of Ohio, (No. 2), 294 U. S. 79; Knoxville v. Knoxville Water Co., 212 U. S. 1; Willcox v. Consolidated Gas, 212 U. S. 19; Northern Pacific Railway v. North Dakota, 216 U. S. 579; Cedar Rapids Gas Light Co. v. Cedar Rapids, 223 U. S. 655; City of Louisville v. Cumberland Tel. & Tel. Co., 225 U. S. 430, 436; Brush Electric Co. v. Galveston, 262 U. S. 443; Lindheimer v. Illinois Bell Tel. Co., 292 U. S. 151.

during the progress of the rate proceeding, the experience factor is made available to the Pennsylvania Commission before the determination of final rates. This section provides a device whereby the relationship of lower rates and increased use may be tested by experience while the interests of the investors are safeguarded against loss during the experimental temporary period.

The practical advisability, from the standpoint of both consumers and company, of providing experience data for use in predicting the results of final rates finds demonstration in the present record through the actual experience of appellee in connection with rate reductions.

Effective September 1, 1933, a reduction of retail and wholesale power rates was made, which appellee calculated would reduce its annual revenues in the amount of $32,300. (R. 147) Instead of a reduction, the 1934 revenues showed an increase over the 1933 revenues in the amount of $69,197. (R. 148). Effective February 7, 1935, a reduction of residential and commercial rates was made which appellee calculated would reduce its annual revenues in the amount of $130,700. (R. 147). Instead of a reduction, the 1935 revenues showed an increase of $6,092 over the 1934 revenues. (R. 149). Effective September 1, 1935, the high-tension power interchange rates were reduced, and appellee calculated its annual revenues would be reduced in the amount of $15,000. (R. 147). Instead of a reduction, the revenues for the first six (6) months of 1936 showed an increase of $36,259 over the revenues for the same period in 1935. (R. 149).

We submit that the primary object of Section 310 is to facilitate prompt action, by enabling the Commission, where the public interest so requires, to establish reasonable experimental rates during the progress of a rate proceeding. As a result of this change in procedure, the consumer may have the prompt benefit of reduced rates, or the utility the prompt benefit of increased rates, when warranted by the facts, the interests of investors are safeguarded against loss, the public utility companies will have an incentive to do everything in their power to aid in the prompt and expeditious determination of the rate proceeding; and the Commission will have a survey of actual experience under the temporary rates to guide its determination of final rates.

II.

SECTION 310 OF THE PENNSYLVANIA PUBLIC UTILITY LAW IS CONSTITUTIONAL

A.

Judicial Consideration of Temporary Rates.

A temporary rate order issued pending the termination of rate proceedings has been upheld by this Court. In **The New England Divisions Case,** 261 U. S. 184, a temporary rate order was issued by the Interstate Commerce Commission prescribing a division of joint rates among numerous railroads, and increasing the division or share which the New England roads would receive. The order was made before complete analysis of all available evidence, was to

continue in force until further order of the Commission, and was left open for correction upon application of any railroad. The Commission did not consider each division, each road, and each rate separately, since the need for a decision was urgent and the roads numerous, and it appeared that the delay involved in making a detailed analysis would result in prejudice to the New England roads. This Court, in sustaining the provisional action of the Commission, stated (page 201):

> "A hearing may be a full one, although the evidence introduced does not enable the tribunal to dispose of the issues completely or permanently; and although the tribunal is convinced, when entering the order thereon, that, upon further investigation, some changes in it will have to be made. To grant under such circumstances immediate relief, subject to later readjustments, was no more a transfer of revenues pending a decision, than was the like action, in cases involving general increases in rates, a transfer of revenues from the pockets of the shippers to the treasury of the carriers. **That the order is not obnoxious to the due process clause, because provisional, is clear. If this were not so, most temporary injunctions would violate the Constitution.**" (Emphasis supplied).

The fact that a rate order is to remain in effect only for a temporary period will not prevent a utility, in the absence of a statutory recoupment provision, from seeking the aid of equity, if confiscation can be shown. In the case of **Prendergast v. New York Telephone Co.**, 262 U. S. 43, the New York Commission had ordered a reduction of the rates of the New York Telephone

Company during the pendency of a rate case against the company. The statute under which this order was issued made no provision for repayment of loss which might result from such temporary rates. The company, complaining that the reduced rates were confiscatory, sought an injunction in a Statutory Federal Court. The temporary injunction sought for was issued and, upon appeal to this Court, the action of the Statutory Court was upheld. In the course of its opinion, the Court said (pp. 49, 51):

> "Nor did the fact that the orders of the Commission merely prescribe temporary rates to be effective until its final determination, deprive the Company of its right to relief at the hands of the court. The orders required the new reduced rates to be put into effect on a given date. They were final legislative acts as to the period during which they should remain in effect pending the final determination; and if the rates prescribed were confiscatory the Company would be deprived of a reasonable return upon its property during such period, without remedy, unless their enforcement should be enjoined. Upon a showing that such reduced rates were confiscatory the Company was entitled to have their enforcement enjoined pending the continuance and completion of the rate-making process.
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> * * * * *
>
> "Here the Commission had prescribed temporary rates which were found to be confiscatory, which were to continue in effect pending the final determination of the Commission after its investigation had been completed; and no date had been fixed for the completion of this investigation or the final hearing. The Company meanwhile could only be protected from loss by injunction; while,

> on the other hand, its subscribers were protected by the bond which was required for the return of the excess charges collected if the injunction should be thereafter dissolved. * * *"

Any rate order, be it temporary or final, which provides for an inadequate return, in the absence of statutory recoupment provisions, will confiscate the utility's property since a utility cannot recover past losses by future rates. See **Galveston Electric Co. v. Galveston,** 258 U. S. 388. But we are convinced that the Prendergast case plainly implies that, had proper statutory provision been made to reimburse the utility for possible loss resulting from temporary rates, the utility could not have supported a claim of confiscation.

To meet the criticism of the Prendergast case, the New York Legislature amended its Public Service Law to include the following provisions (New York Public Service Law, Section 114, L. 1934 Chap. 287), which are quoted at length to demonstrate their similarity to the provisions in issue in the case at bar:

> "'Sec. 114. **Temporary rates.** To facilitate prompt action by the commission in proceedings involving the reasonableness of the rates of any public utility and to avoid delay in any such rate proceeding, the commission is hereby authorized to require any public utility company to establish, provide and maintain continuing property records, including a list or inventory of all of the physical property actually used in the public service, and to require any public utility company to keep its books, accounts and records in such manner as to show currently the original cost of said physical property and the reserves accumulated to provide

for the retirement or replacement of said physical property.

"'The commission may, in any such proceeding, brought either on its own motion or upon complaint, upon notice and after hearing, if it be of opinion that the public interest so requires, immediately fix, determine and prescribe temporary rates to be charged by said utility company pending the final determination of said rate proceeding. Said temporary rates so fixed, determined and prescribed shall be sufficient to provide a return of not less than five per centum upon the original cost, less accrued depreciation, of the physical property of said public utility company used and useful in the public service, and if the duly verified reports of said utility company to the commission do not show the original cost, less accrued depreciation, of said property, the commission may estimate said cost less depreciation and fix, determine and prescribe rates as hereinbefore provided.

"'Temporary rates so fixed, determined and prescribed under this section shall be effective until the rates to be charged, received and collected by said utility company shall finally have been fixed, determined and prescribed. The commission is hereby authorized in any proceeding in which temporary rates are fixed, determined and prescribed under this section, to consider the effect of such rates in fixing, determining and prescribing rates to be thereafter charged and collected by said public utility company on final determination of the rate proceeding.'"

The New York Court of Appeals held, in **Bronx Gas & Electric Co. v. Maltbie,** 271 N. Y. 364, 3 N. E. (2d) 512, that the quoted provisions satisfied the deficiencies

mentioned in the Prendergast case, and declared that the imposition of temporary rates thereunder constituted only a step in the legislative process, which step was not final in character, and could not possibly result in confiscation, since any losses arising therefrom must be made up to the utility in the rates finally prescribed. **The net effect of this holding is that temporary rates are not subject to judicial review on the question of confiscation during the temporary period they remain in effect, where the law under which they are prescribed provides for recoupment. We respectfully urge the Court to enunciate this principle as the law of the case at bar.**

B.

Section 310 Provides An Adequate Method for Recoupment of Loss, If Any, While Temporary Rates Are In Effect, and Thereby Prevents Confiscation.

It is realized that the courts have, from time immemorial, been the guardians of the rights and property of the citizens against confiscation. It is also realized that the effect of our contentions is to defer the exercise of that guardianship with reference to substantive—as distinct from procedural—issues, pending final legislative rate action by the Commission. To justify such postponement, we recognize that the property owner must be afforded reasonable protection, in that there must be no possibility that the public service of the utility will be impaired by reason of insufficient funds, pending final determination of reasonable rates, and, in addition, the loss suffered by reason of temporary rates which are later found to be too low, must be restored.

Section 310(a) and Section 310(e) of the Pennsylvania Public Utility Law clearly and indubitably furnish the protection we recognize as necessary.

Section 310(a) provides that the temporary rates prescribed thereunder shall yield a return of not less than 5 per cent on the original cost less depreciation of the used and useful utility property. To fulfill this absolute requirement, it is first necessary for the Commission to ascertain the original cost of the property and to determine proper depreciation. As pointed out by the New York Court in the Bronx Case (3 N. E. (2d) 512, 515), "there is some accuracy in these figures; they can be fixed with some certainty and are not dependent altogether upon speculative expert opinion."

After the Commission has properly determined the rate base in accordance with the requirements of the law, it must allow the utility all reasonable and proper operating expenses. Then, and only then, can it compare the allowable revenues with the actual revenues, to determine whether or not a temporary rate reduction is possible. Thus, all of the ordinary running expenses of the utility must be allowed, and any reduction must come from revenues over and above such ordinary expenses.

But, the Commission must go farther. It must allow a return to the investor, at a rate not less than 5 per cent on the original cost less depreciation of the utility property. Thus, under Section 310(a) of the

Public Utility Law, some return on investment must always be provided.

It is to be presumed that all regulatory bodies will perform their functions with reasonable dispatch and, where this presumption proves false, the remedies of injunction and mandamus are available. The Court has held, in **Virginian Ry. Co. v. System Federation No. 40**, 300 U. S. 515, 551, that:

> "It is a familiar rule that a court may exercise its equity powers, or equivalent mandamus powers, United States ex rel. Greathouse v. Dern, 289 U. S. 352, 359, to compel courts, boards, or officers to act in a matter with respect to which they may have jurisdiction or authority, although the court will not assume to control or guide the exercise of their authority. Interstate Commerce Comm'n. v. Humboldt S. S. Co., 224 U. S. 474; Louisville Cement Co. v. Interstate Commerce Comm'n., 246 U. S. 638; see Work v. United States ex rel. Rives, 267 U. S. 175, 184; Wilbur v. United States ex rel. Kadrie, 281 U. S. 206, 218."

It is also to be presumed that regulatory bodies will act fairly and reasonably in all other respects. But, where arbitrary or unfair Commission action is shown to violate fair play, the Courts need not hold the prescribed rates to be confiscatory in order to justify intervention to protect the company: **West v. Chesapeake & Potomac Telephone Co.**, 295 U. S. 662.

However, as stated, it is recognized that if the return permitted by the temporary rate order is ultimately determined to be too low, the investor has been deprived of income to which he is entitled, and the Pennsylvania Legislature has provided in Section

310(e) that the investor shall have restored to him the amount of any such loss.

The Court below was of opinion that the recoupment provision of Section 310(e) is not entirely effective because it does not provide for interest on the money which the company may lose during the trial period, and because the company, in view of Section 305 of the Public Utility Law, abolishing deposits to secure future payments of rates, is without remedy against consumers who may discontinue service or move out of the territory. These objections of the Court below are groundless.

The first objection is invalid, because a statute authorizing the taking of property is not unconstitutional merely because of failure expressly to provide for payment of interest during the interim between the taking and payment of compensation, since the right to interest is necessarily implied: **United States v. Rogers,** 255 U. S. 163; **Brooks-Scanlon Corp. v. United States,** 265 U. S. 106; **Simms v. Dillon,** 193 S. E. 331.

As to the second objection, the abolition of deposits to secure payment of future rates has nothing to do with the effectiveness of the company's recoupment. It is not the deposits of those who have discontinued service from which the statute requires recoupment, but from rates paid by those who are continuing to be served by the company. Consequently, this objection of the Court below is wholly immaterial to the issue.

The main attack on the sufficiency of the recoupment provision made by appellee in the Court below was based on the proposition that no real guarantee is made for the payment of recoupment. Appellee contended that, since neither the credit of the Commonwealth of Pennsylvania is pledged for its payment, nor is any specific fund or body of consumers liable therefor, the recoupment provided is illusory. We submit that these considerations do not show the recoupment provision to be ineffective in any way.

Common experience proves that public demand for utility service is not substantially influenced by minor fluctuations in rates. It cannot be successfully argued that the slight increase in final rates which might be necessary to reimburse a utility for the loss sustained during a brief period under temporary rates would detrimentally affect either the number of a utility's consumers or the amount of their consumption.

In addition to being able to look to a stable and permanent body of the public for recoupment, the utility possesses an exceptional, salutary and effective method for the enforcement of payment of recoupment. The right of the utility to discontinue service for non-payment of the recoupment rate found reasonable by the Commission will, in all but a very small percentage of instances, result in the consumer making prompt payment of the recoupment rate as an alternative to losing the virtually indispensable service of the utility. We submit that this ability to look to a body of the public from which it can readily exact recoupment fully protects the utility.

Certainly, any fear that appellee would not be able to recoup the difference between revenues obtained under temporary rates and those permitted by final rates, is wholly illusory. It is inconceivable that a company which had admittedly been collecting $250,000 annually in excess of reasonable revenues (R.777) will find itself unable to collect a sum in recoupment of temporary losses.

The contention raised in the Court below that the Commission would have no right as a matter of law to require recoupment from a new consumer is without merit. The Court below did not accept this contention, and it is fully answered by the words of the New York Court in the Bronx Case, (3 N. E. (2d) 512, 516) where the Court said:

> "* * * A few consumers may be new customers paying what the old consumer should have paid. Such instances are of minor importance; the percentage must be very small. We can never work our institutions of government if we refine matters to such an extent that we have to consider all these little details. The Constitution expresses fundamental principles, and if in the main these have been observed, this is all that can be required. Besides, when we speak of the consumer —the customer—we mean the public, not individuals. See San Diego Land & Town Co. v. Jasper, 189 U. S. 439, 23 S. Ct. 571, 47 L. Ed. 892."

See also opinion of Judge Johnson, **Edison Light & Power Co. v. Driscoll,** 21 F. Supp. 1, 4.

The argument in this regard is made, not on behalf of the ratepayers, who might be required to bear the

increase, but on behalf of the utility. The utility cannot reasonably be heard to complain that its recoupment may burden the wrong people.

Appellee also advanced the contentions that Section 310(e) is deficient because it does not provide for possible credit impairment and loss of interest, resulting from inadequate temporary rates, nor for the time and rate of recoupment. We submit that Section 310(e), by requiring the Commission to allow recoupment, has entrusted these matters without specific mention of them to the sound administrative discretion of the Commission. In advance of any abuse by the Commission of the command of the Legislature to consider the effect of temporary rates in fixing final rates, this Court will not pronounce anticipatory judgment as to whether or not the Commission will allow proper recoupment. See **National Fertilizer Ass'n. v. Bradley,** 301 U. S. 178; **Continental Baking Co. v. Woodring,** 286 U. S. 352; **United States v. Illinois Central Railroad Co.** 291 U. S. 457.

The taking of property before determination of the amount of compensation to which the owner is entitled, does not violate the Fourteenth Amendment: **Dohany v. Rogers,** 281 U. S. 362. So long as sufficient security is made available for reasonably prompt payment of compensation, and there is adequate provision for recourse to the security, the requirement of just compensation is met, and confiscation does not result: **Joslin Manufacturing Co. v. Providence,** 262 U. S. 668; **Bragg v. Weaver,** 251 U. S. 57; **Crozier v. Krupp,** 224 U. S. 290.

Although the cases deciding these principles relate to eminent domain statutes, the principles can be applied with equal, if not greater, force to a temporary rate statute. If an individual, when his property is taken by the state in the public interest, cannot claim confiscation if just compensation is provided, we can conceive no greater right in a utility, whose property is regulated by the state in the public interest, to be permitted to claim confiscation when such regulation inadvertently results in a taking for which just compensation is provided. In the taking of property by eminent domain, the private interest of the land owner is subordinated to purposes of public improvement. We represent that, similarly, the private advantage of the utility investor should be subordinated to the interest of the public in effective rate regulation.

In view of these principles, and the above demonstration that Section 310(e) fully and adequately provides for just compensation if any property of the utility is taken by virtue of inadequate temporary rates, the conclusion is inevitable that such taking cannot be considered confiscatory, and does not violate the Fourteenth Amendment. It is, therefore, respectfully submitted that the temporary rates in the instant case should not have been enjoined on the ground that they resulted in confiscation, and that the action of the Court below, in basing its decree partly upon a finding of confiscation, constitutes reversible error.

C.

Section 310 Does Not Restrict the Commission as to Elements of Value It May Consider in Prescribing Temporary Rates, and Authorizes the Prescription of Just and Reasonable Rates.

We have contended that rates prescribed under Section 310, due to their temporary character and the fact that just compensation is provided for any possible loss occasioned thereby, are not subject to judicial review on the issue of confiscation. Independently of this contention, however, and even supposing the contention to be invalid, we submit that Section 310(a) clearly provides for the prescription of non-confiscatory rates, and does not, in any manner, violate the Fourteenth Amendment to the Constitution of the United States.

The New York Court, in the Bronx case, proceeded on the theory that the New York temporary rate provision, earlier quoted, furnishes a mechanical formula for the imposition of temporary rates, and indicates, in the course of its opinion, that the Commission must, in all cases, determine temporary rates on the sole basis of original cost less depreciation. The Court below took a similar view of the provisions of Section 310(a) of the Pennsylvania Law and construed them as limiting the Commission, in the prescription of temporary rates, to the consideration of only one element of value; namely, original cost, to the exclusion of all other value criteria. For

this reason, the Court declared Section 310(a) unconstitutional.

We contend that no language in Section 310(a) warrants or justifies the construction of the Court below, and that such construction is contrary to the clearly expressed intent of the Legislature.

It is earnestly submitted that Section 310(a) does not in any manner whatsoever restrict the Commission as to the elements of value which it may consider in prescribing temporary rates. The only restriction contained in Section 310(a) is that temporary rates in all cases must be "sufficient to provide a return of not less than five per centum upon original cost less accrued depreciation of the physical property of the utility." The words "not less" obviously connote a minimum limitation and not an exclusive standard, and the Commission may employ whatever method of arriving at rate base and whatever rate of return is proper under the circumstances so long as the return provided by the temporary rates is not less than 5 per cent of original cost less depreciation.

The fact that the Commission, in complying with this restriction, is bound to consider the original cost of a utility property, in no way sustains the conclusion that consideration of any other value element is not authorized. If reproduction cost, or any other value element, must be considered, and a rate of return in excess of 5 per cent must be allowed, certainly Section 310(a) does not preclude the Commission from such consideration or allowance.

Appellants further submit that Section 310(a) of the Public Utility Law not only does not impair a public utility's constitutional safeguard against confiscation, but also provides an additional safeguard to utilities in the field of non-confiscatory regulation by restricting the Commission in the manner above stated. It is possible, within the provisions of the Constitution, as interpreted by this Court, to establish temporary rates which would yield operating revenues in an amount less than 5 per cent of original cost less depreciation when the particular circumstances justify it. By setting a limit below which the Commission cannot go in imposing temporary rates, the Legislature has, in those cases, provided not only for non-confiscation itself, but also for a minimum non-confiscatory temporary rate.

We respectfully represent that a rate provision setting no inflexible standards, and allowing for full observance of the expressions of this Court, as does Section 310(a), cannot possibly be unconstitutional.

The Court below found as a fact that the Commission proceeded under paragraphs (a), (c) and (e) of Section 310 (R. 1126). It concluded that, since appellee does not have continuing property records, the Commission should have proceeded under paragraph (b) of Section 310 (R. 1127). The lower Court apparently placed little reliance upon this holding, since it does not once mention this conclusion in the opinion, which discusses only paragraph (a) and paragraph (e). The conclusion is not supported by reference to any words of the Public Utility Law. A mere glance at

paragraph (b) discloses that the Pennsylvania Legislature, in that paragraph, simply prescribed an **alternative** temporary rate procedure for utilities having no continuing property records. The paragraph **authorizes**, but does not **require**, the Commission to prescribe temporary rates for a utility lacking continuing property records which will satisfy the minimum limitation of the paragraph. The paragraph provides that the Commission "may", for such a utility, prescribe temporary rates satisfying such limitation.

This Court has repeatedly stated that judicial inquiry into the constitutionality of rates looks to effect: **Los Angeles Gas & Electric Corp. v. Railroad Commission of California**, 289 U. S. 287, 304, 305; **West Ohio Gas Co. v. Public Utilities Commission of Ohio, (No. 1)**, 294 U. S. 63, 70. Therefore, the provisions of paragraphs (a), and (b) of Section 310 setting up alternative procedures cannot, ipso facto, be unconstitutional. The difference between the paragraphs lies in the difference in lower limitations below which the Commission cannot go in prescribing temporary rates. The present record does not specifically disclose which limitation would be more advantageous either to the company or the public, in view of the power given the Commission in paragraph (b) to make adjustments. Neither paragraph sets forth any standard or formula to which the Commission must adhere. Constitutional limitations remain in full force and effect, and the Commission is in no way required to violate any such restriction.

III.

RATES THAT AFFORD TO A PUBLIC UTILITY A FAIR RETURN UPON THE PRUDENT ORIGINAL COST OF ITS PROPERTY USED OR USEFUL IN PUBLIC SERVICE SHOULD NOT BE HELD CONFISCATORY.

A.

Judicial Tests of Confiscation and Scope of Judicial Review.

Regardless of the disposition of the contentions urged in part II of this brief the rates prescribed in the Commission order should not be enjoined unless they violate the Federal Constitution by resulting in the confiscation of property of the appellee.

It is well established that judicial interference with the legislative function of rate making will be resorted to only if the rates prescribed by the Commission, in the totality of their effect, result in the confiscation of the utility's property: **United Gas Co. v. Texas,** 303 U. S. 123, 143. Further, since "in the question of rate making a strong presumption exists in favor of the conclusions reached by an experienced administrative tribunal" (**Darnell v. Edwards,** 244 U. S. 564, 569), it is well established that the fact of confiscation must be clearly shown by the complaining public utility: **Los Angeles Gas & Electric Corp. v. Railroad Commission of California,** 289 U. S. 287, 305; **St. Joseph Stock Yards Co. v. United States,** 298 U. S. 38, 53.

The scope of review in determining the question of confiscation has been clearly stated by the Court in a number of cases. In **West Ohio Gas Co. v. Public Utilities Commission of Ohio, (No. 1)**, 294 U. S. 63, at page 70, the Court stated:

> "Our inquiry in rate cases coming here from the state courts is whether the action of the state officials **in the totality of its consequences** is consistent with the enjoyment by the regulated utility of a revenue something higher than the line of confiscation. If this level is attained, and attained with suitable opportunity through evidence and argument (Southern Ry Co. v. Virginia, 290 U. S. 190) to challenge the result, there is no denial of due process, though the proceeding is shot through with irregularity or error." (Emphasis supplied)

To demonstrate the fact that rates are just and reasonable, and do not violate constitutional provisions, it is first necessary to determine the test by which the issue of confiscation is to be resolved.

Following a line of cases that were more or less indefinite as to the elements that must be considered in determining the basis of the rates of public utilities, there emerged from the decision of the Supreme Court in **Smyth v. Ames,** 169 U. S. 466, the rule that one element essential to the determination of value is the cost of reproduction. The crux of the Court's opinion is (p. 546, 547):

> "We hold, however, that the basis of all calculations as to the reasonableness of rates to be charged by a corporation maintaining a highway

under legislative sanction must be the fair value of the property being used by it for the convenience of the public. And, in order to ascertain that value, the original cost of construction, the amount expended in permanent improvements, the amount and market value of its bonds and stock, the present as compared with the original cost of construction, the probable earning capacity of the property under particular rates prescribed by statute, and the sum required to meet operating expenses, are all matters for consideration, and are to be given such weight as may be just and right in each case. We do not say that there may not be other matters to be regarded in estimating the value of the property. What the company is entitled to ask is a fair return upon the value of that which it employs for the public convenience. On the other hand, what the public is entitled to demand is that no more be exacted from it for the use of a public highway than the services rendered by it are reasonably worth.* * *"

The above decision has been interpreted to mean that one of the controlling factors which must be taken into consideration in determining the rate base of a utility property is the cost to reproduce the property.

We respectfully urge your Honorable Court to announce the principle that the proper test to determine whether or not rates violate the Federal Constitution is whether or not the annual gross revenues permitted by the rates provide, over and above operating expenses and an allowance for depreciation, a compensatory return upon the prudent original cost of the utility property dedicated to the public use.

The position which the Pennsylvania Commission urges the Court to take in its decision in this case will necessitate a modification of **Smyth v. Ames** and the decisions which have followed its authority. We respectfully represent that such a step is necessary if the end of regulation is to be accomplished, namely, rates that are just and reasonable to the consumer and compensatory to the utility.

B.

The Reproduction Cost Doctrine is Unsound and Unworkable.

1. The Reproduction Cost Doctrine Hinders Effective Rate Regulation.

Regulatory commissions have attempted to comply with the decision in **Smyth v. Ames,** interpreted as requiring consideration of reproduction cost. Many of these commissions, including the Pennsylvania Commission, have found that the reproduction cost principle, far from being a guide to the solution of the problem, has proved an element which makes the task of proper rate regulation almost impossible.

Under the reproduction cost rule of **Smyth v. Ames,** it is necessary to embark upon the conjectural calculation of all the details of cost of reconstructing the property under present-day conditions. It is necessary to determine present-day prices of each item of property. Where items are no longer manufactured or available, an estimate must be made of what it would cost to reproduce them if someone were manufacturing them. Present-day labor prices are applied to deter-

mine what it would cost to install this theoretical plant. Here the theory again departs from certainty and actuality, and requires the conjecture as to whether or not the construction conditions now existing should apply, and whether modern devices should be used.

The illogical character of the reproduction cost theory is indicated by the Court's rejection of hypothetical repaving costs: **Des Moines Gas Co. v. Des Moines,** 238 U. S. 153, 172 and **Dayton Power & Light Co. v. Public Utilities Commission of Ohio,** 292 U. S. 290, 311, and the rejection of hypothetical cost of financing: **Galveston Electric Co. v. City of Galveston,** 258 U. S. 388, 397; **Wabash Valley Electric Co. v. Young,** 287 U. S. 488, 500; **Los Angeles Gas & Electric Corp. v. Railroad Commission of California,** 289 U. S. 287, 310; **Dayton Power & Light Co. v. Public Utilities Commission of Ohio,** 292 U. S. 290, 310.

After the plant is physically reconstructed in theory, and all the property and labor costs are included, additional theoretical costs are added, many of which were never experienced by the utility, but occur only in the mind of the reproducing theorist. Architects' fees are added, despite the fact that in many instances if an architect to-day produced the type of building which is actually being used, he might encounter difficulty in collecting his fee, as well as jeopardize his professional standing. Calculations are made as to what the interest charges would be during the course of construction. Engineering experts, it is said, would be called in; legal fees would allegedly be incurred in tracing the title to land which, in fact, has been owned

by the utility for many, many, years. These overheads or intangibles have literally flooded the calculation of the reproduction cost until, in some instances, their total amounts to 30 per cent of the actual physical costs of the property. In the present case, the company figure is approximately 24% (R. 19).

It is not unexpected, therefore, that, in certain instances, reproduction cost estimates during periods of low prices exceed the actual original cost of plants constructed in periods of prevailing high prices. Such was the condition disclosed by the record presented to the California Commission in the recent Pacific Gas & Electric Company litigation (1 P. U. R. (N. S.) 1).

But, alas, the Commission cannot rest with consideration of a single reproduction cost estimate. Both sides appear with elaborate reproduction cost estimates, although only by the title of the exhibits could one identify anything common to those presented by the companies and those presented by their opponents. Reproduction cost estimates submitted in rate cases vary widely. In one Pennsylvania case the range was from approximately $22,000,000 to approximately $58,000,000: **Scranton Spring Brook Water Service Co. v. Public Service Commission,** 119 Pa. Superior Ct. 117.

It is primarily the necessity for unravelling these differences to determine the propriety of assumptions

and findings that so delays rate cases.[1] While time and expense are taken up by cross-examination on theoretical hypothetical conjectures, and in considering all of these detailed matters, material prices are changing and labor costs are fluctuating. It is these changes in prices and costs which render the theory of reproduction cost useless to the regulatory body. Often, by the time a reproduction cost rate base is determined, it is out of date.

Smyth v. Ames, and the other decisions upholding the reproduction cost doctrine, do not constitute the only expressions of judicial opinion upon the subject of utility valuation. In 1922, a concurring opinion was written in the case of **Southwestern Bell Tel. Co. v. Public Service Commission,** 262 U. S. 276 by Mr. Justice

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[1] A very typical example of what faced the Pennsylvania Court in a case on appeal from the Pennsylvania Commission is afforded by *Scranton-Spring Brook Water Service Co v. Public Service Commission,* 119 Pa. Superior Ct. 117. Complaints were filed in 1928 with the Pennsylvania Commission against a tariff of the Scranton-Spring Brook Water Service Company. The decision is dated October 2, 1935 and states (119 Pa. Superior Ct. 122): "These appeals arise from one record and were argued together. They will be disposed of in one opinion. The record is monumental in size. When it first came into this court (See Scranton-Spring Brook Water Service Co. v. P. S. C., 105 Pa. Superior Ct. 203) it consisted of 4,000 pages of printed testimony and fourteen large quarto volumes of photostatic exhibits. On these appeals it has been increased by 1,100 pages of printed testimony and five additional quarto volumes of photostatic exhibits, taken pursuant to interim reports of January 3, 1933 and February 7, 1933, respectively."

Brandeis, which opinion, concurred in by Mr. Justice Holmes,[1] states clearly and concisely the principal objections to the doctrine of **Smyth v. Ames** in the following language, at page 289:

> "I concur in the judgment of reversal. But I do so on the ground that the order of the state commission prevents the utility from earning a fair return on the amount prudently invested in it. Thus, I differ fundamentally from my brethren concerning the rule to be applied in determining whether a prescribed rate is confiscatory. The Court, adhering to the so-called rule of Smyth v. Ames, 169 U. S. 466, and further defining it, declares that what is termed value must be ascertained by giving weight, among other things, to estimates of what it would cost to reproduce the property at the time of the rate hearing.
>
> "The so-called rule of Smyth v. Ames is, in my opinion, legally and economically unsound. The thing devoted by the investor to the public use is not specific property, tangible and intangible, but capital embarked in the enterprise. Upon the capital so invested the Federal Constitution guarantees to the utility the opportunity to earn a fair return. Thus, it sets the limit to the power of the State to regulate rates."
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> * * * * * *

And, at page 306:

> "The adoption of the amount prudently invested as the rate base and the amount of the capital charge as the measure of the rate of return would

[1] See also Pacific Gas Co. v. San Francisco, 265 U. S. 403, 416; McCardle v. Indianapolis Water Co., 272 U. S. 400, 421; St. L. and O'Fallon R. Co. v. United States, 279 U. S. 461, 488 and 549; United Railways v. West, 280 U. S. 234, 255; Railroad Commission of California v. Pacific Gas & Electric Co., 302 U. S. 388; McCart v. Indianapolis Water Co., 302 U. S. 419, 423.

give definiteness to these two factors involved in rate controversies which are now shifting and treacherous, and which render the proceedings peculiarly burdensome and largely futile. Such measures offer a basis for decision which is certain and stable. The rate base would be ascertained as a fact, not determined as matter of opinion. It would not fluctuate with the market price of labor, or materials, or money. It would not change with hard times or shifting populations. It would not be distorted by the fickle and varying judgments of appraisers, commissions, or courts. It would, when once made in respect to any utility, be fixed, for all time, subject only to increases to represent additions to plant, after allowance for the depreciation included in the annual operating charges. The wild uncertainties of the present method of fixing the rate base under the so-called rule of Smyth v. Ames would be avoided; and likewise the fluctuations which introduce into the enterprise unnecessary elements of speculation, create useless expense, and impose upon the public a heavy, unnecessary burden."

The thoughts expressed in this opinion have been adopted as the expression of a school of thought that has continually grown until today, it is respectfully represented, the majority of the thoughtful writers on the subject of the valuation of public utilities are of the view that the doctrine of prudent investment should be substituted for the reproduction cost doctrine of **Smyth v. Ames.**

Many non-judicial authorities may be cited which stress the failure of the **Smyth v. Ames** doctrine to carry out the duty which it is designed to perform in

the regulatory procedure. A striking example is the treatise by James C. Bonbright, "The Valuation of Property," Volume II, pp. 1081, 1082, (1937):

> "The sharp disagreement among American economists as to what constitutes a proper rate base makes all the more striking their apparently unanimous agreement that, whatever this base should be, the one measure which is outlawed is the very measure which the Supreme Court has held to be controlling—namely, the 'value' of the properties as of the time when the rates are under consideration."

Upon the merits of the prudent investment theory, which is herein urged as the proper alternative to the **Smyth v. Ames** fair value doctrine, the same text states (pp. 1085, 1086):

> "Justice Brandeis has been the most distinguished exponent of the prudent-investment principle,[9] which has been favored by the majority of economists who have written recently on the subject.[10] Its primary advantages, according to its defenders, are twofold. In the first place, it avoids the hopelessly prolonged and expensive contro-

[9] "See his concurring opinion (dissenting as to method) in the Southwestern Bell Telephone case, *supra* note 7."

[10] "Bauer and Gold defend the 'prudent-investment' basis in the monograph mentioned at the beginning of this chapter. For a defense by the present writer, see his 'Railroad Valuation with Special Reference to the O'Fallon Decision,' 18 *Am. Econ. Rev. Supp.* 181 (March, 1928); 'The Economic Merits of Original Cost and Reproduction Cost,' 41 *Harv. L. Rev.* 593 (1928); and the Minority Report of Commissioners Walsh, Bonbright, and Adie, State of New York, Commission on the Revision of the Public Service Commission Law (Albany, 1930). See also Mosher and Crawford, *Public Utility Regulation* (New York, 1933); Jones and Bigham, *Principles of Public Utilities* (New York, 1931); and articles cited in the last two textbooks.

versies attendant on a procedure of rate making which calls for periodic or occasional reappraisals. This advantage is not to be brushed aside as involving a minor issue of 'administrative convenience.' The history of regulation under the 'fair-value' rule of the Supreme Court is believed to prove that rate control by valuation is not merely difficult—it is practically impossible.

"In the second place, the prudent-investment rule would greatly reduce the speculative character of public utility investments. Under the replacement-cost rule, no less than under that compromise procedure of rate making called for by the 'fair-value' doctrine, investors in public utility equities are compelled to gamble on the future valuations that will be placed upon the properties. The prudent-investment principle, to be sure, will not remove the speculative feature from utility stocks; but it will at least minimize it.

"The greater safety of utility securities under the prudent-investment method of control is held to be advantageous, not alone from the standpoint of small investors and of financial institutions, but also from the standpoint of ratepayers. * * *"

A well considered article recently appeared in the "Columbia Law Review," prepared by Robert L. Hale entitled "Conflicting Judicial Criteria of Utility Rates —The Need For a Judicial Restatement" (38 **Columbia Law Review 959**) in which the writer urges that a clear and definite statement be made by the Court substituting some workable formula of the **Smyth v. Ames** rule of determining the value of utility properties.

We respectfully refer your Honorable Court to Appendix A of the brief of the Federal Power Commission filed with the Court in the case of **Railroad Commission**

of California v. Pacific Gas & Electric Company, 302 U. S. 388. That appendix contains an excellent summary of the authorities on the subject.

We cannot place too much stress upon the necessity which we feel exists for a clarifying decision authorizing a state commission to determine utility rates upon a workable and just formula, and we submit that the proper formula is a compensatory rate of return upon the prudent original cost of the property devoted to public use.

2. The Reproduction Cost Doctrine is Unsound from an Engineering Standpoint.

In 1911, the American Society of Civil Engineers appointed a special committee to formulate principles and methods for the valuation of railroad properties and other utilities. This committee filed its final report on October 28, 1916, and the report is published in Transactions of the American Society of Civil Engineers, Vol. LXXXI, December, 1917, at page 1311. This report was compiled by a committee of engineers actively engaged in different types of engineering, and clearly reflects the difficulties of the engineering profession at that time with regard to the principles of valuation. (See preface of report)[1]

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[1] "* * * the fact that nine men of widely different training and experience, practicing in different professional lines and fields, have been able to come finally to common belief upon most of the subjects discussed—the principles which should control the valuation of normal public utility properties—leads the Committee to hope that this report may be helpful to others, and may serve to clarify this very involved subject, to the common advantage of public service corporations and the public served, by aiding in the establishing of procedure and in the reducing of the uncertainties of valuation and rating of public utility properties."

It may not be amiss to state that this report is today regarded by many engineers and others as one of the outstanding expositions of the subject. The report includes a chapter on original cost in which it defines clearly and succinctly the principles of original cost and the methods of determining such cost (page 1354 of report):

> "In the absence of any generally accepted or well-defined legal meaning of this term, the Committee has defined it as 'the cost of the original construction, plus all charges against capital proper, under approved accounting principles, for expenditures incurred thereafter, and minus all proper credits to capital for the cost of property which has been disposed of or othewise retired.'
>
> "Under this definition, the original cost to date of a property is the first cost of the identical property units now in use, including overhead charges. This definition accords with modern methods of accounting, by which the cost of property retired is credited to the fixed capital account to which it stands charged, or to some corresponding account, and the cost of property, added as a replacement, or otherwise, is debited to the fixed capital account or other corresponding account; it seems, also, to conform more nearly than any other definition with the decisions of the Courts that property which has been retired shall be excluded (excepting its salvage value) when making a valuation."

* * * *

The accounting standards described above as "modern" exist today, and are common to all prescribed classifications of accounts. Such accounting requirements have been in effect for electric utilities since 1919 in Pennsylvania. In addition thereto con-

tinuing property records have been prescribed for many types of utilities including electric utilities. All prescribed accounts, including continuing property records, require the identification of property at its original cost.

The committee report continues with a chapter on "cost of reproduction." In sharp contrast to the clarity and succinctness of the chapter on original cost, this chapter is drawn out, sets forth divergent views, and indicates the maze of problems and the lack of unanimity of thought upon this subject. Difficulty arises at the outset in the definition of "Cost of Reproduction." At page 1359 of the report it is said:

> "'The estimated cost of reproducing the property without deduction for the loss of value due to age or other causes.'
>
> "The practice of those engaged in valuation work, from the beginning of such work up to the present time, has varied widely in the matter of determining the cost of reproduction. Some base such cost on existing physical conditions, others on historic conditions, and still others combine the two. Some engineers have included only those physical property units which were actually created in the construction of the property, that is, they have used historic conditions, as to items of cost, with present-day prices for labor and material. Others have used substitute units, or historic prices, or original instead of present methods of work, and still others have used original conditions, original prices, and original methods, in making an estimate or reproduction cost.
>
> "This failure of engineers engaged in valuation practice to agree on a uniform conception of re-

production has cast some doubt on the real worth of Cost of Reproduction as one of the measures value."

Following a recital of the legal and practical difficulties facing the profession, the report concludes (page 1377):

> "*Conclusion as to the Proper Conception of Reproduction.*—In line with the foregoing discussion, the Committee recommends that reproduction estimates be based on the assumption that the identical property is to be reproduced, rather than a substitute property; that while apparent present-day condition, that would affect the cost of reproducing the property, must be considered, in any logical estimate, yet history must also be considered to determine what is to be reproduced, the conditions under which it is to be reproduced, and how the estimate must be made; that for all those items, concerning which there can be no doubt, the engineer should use the basis plainly applying, **and that for those that are doubtful, or have been questioned, he should present the effect of the use of the different bases clearly, that the determining body may have the data for a wise decision; and that normal present conditions shall determine the prices and methods for doing the work.**" (Emphasis supplied.)

The emphasized portion of the above quotation is, we respectfully submit, a devastating criticism of the theory of cost of reproduction. The theory is not susceptible to accurate conclusion by those most learned in the details of its formulation. If the experts of the engineering profession must leave to the wise decision of regulatory commissions the guess of the cost of re-

production, is it amiss to declare that the same is not susceptible to accurate calculation?

This learned committee report, carefully considered for a period of several years during the formative stage of utility regulation, regarded reproduction with a doubt and the years that have followed have justified the doubt. We most strongly reiterate the fact that only by casting aside the unworkable principle that regulatory bodies must determine this undeterminable value of reproduction cost, will regulation be able to progress.

3. The Reproduction Cost Rule is Unsound from an Accounting Standpoint.

There is no set of accounts which a regulatory commission can require a utility to keep in order to disclose the various elements of value now required by judicial mandate of **Smyth v. Ames** to be considered in the determination of the rate base; and, obviously, no regulatory body can be expected to exercise effective control of utility rates when reproduction costs, one of the principal elements to be considered in the rate base, cannot be currently reflected on a utility's books of account.

Recently, uniform systems of accounts have been adopted generally by state and federal regulatory bodies throughout the country which provide that original cost (estimated if not determinable from the records) of utility plants in service shall be currently shown on the books of account. The constitutionality of the original cost provision in the system of accounts

prescribed by the Federal Communications Commission has been upheld: **American Tel. & Tel. Co. v. United States,** 299 U. S. 232. To insure the prompt availability of a reliable record of original cost, certain state commissions have supplemented the uniform system of accounts by prescribing rules and regulations designed to classify the various units of physical property as related to the original cost. These supplemental records are known as "continuing property records." The Pennsylvania Commission has issued orders requiring all electric utilities, whose fixed capital exceeds $100,000, and all natural and manufactured gas utilities with annual gas operating revenues in excess of $100,000, to maintain continuing property records.

When these orders have been complied with, there will be available from the books of a utility the original cost of its property; there will be quickly available a statement in dollars and cents of the amount of private capital invested in the property used in public service. It will be a statement that will not be subject to the illusions and guesses of the reproduction cost theory.

As a practical example of the quandary in which the reproduction rule places public utilities in trying to adjust their books in order to have them picture the fluctuating "fair value" of the property of the corporation, we refer to the recent testimony of H. Hobart Porter, President of the American Water Works & Electric Company, Inc., before the Securities and Exchange Commission in the matter of American Water-

works & Electric Company, Inc., The West Penn Electric Company, Docket No. 54-1 46-68, at a hearing held in Washington, D. C., on September 15, 1937, in which the Pennsylvania Commission intervened.

Mr. Porter described the acquisition by American Waterworks and Electric Company, Inc., a Delaware corporation, of the assets of the American Waterworks and Electric Company, Inc., a Virginia corporation, in 1927. He testified that, subsequent to the acquisition, there was a book appreciation in the valuation of the assets in the sum of $51,000,000. This increased valuation was reversed in 1936, because of a "change of fashions"[1], and "we try to change with the fashions."

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[1] At the possible expense of unduly prolonging this brief, we set forth some of the testimony by Mr. Porter in this proceeding as an example of the uncertainty which confronts the management of operating utilities to keep abreast of the reproduction cost rule: (pp. 196, 197, 198, 202)

"Q. Do you recall the valuation of the assets of the American Water Works and Electric Company, Incorporated, the Virginia corporation, just before that merger?

"A. I do.

"Q. What was that figure?

"A. Well, it was some $51,000,000 less than it was later. I do not recall what it was. Mr. Ross can give you all of the details about that.

"Q. But, I understand from that that the Delaware corporation took unto its books assets which had been held by the Virginia corporation at an increased valuation of about $51,000,000.

"A. I think that figure might be $51,000,000 or $52,000,000.

"Q. What was the basis for that increased valuation?

"A. Well, from my point of view, it was embarrassment. I had a call from a distinguished looking old gentleman one day who said, 'I have always had a high opinion of you as a very honorable man. I own stock in the American Water Works. It sells for so many dollars a share and your last annual balance sheet shows that your stock is only carried on your books at very much less than that.

We therefore reiterate that the reproduction cost doctrine is unsound from an accounting standpoint. It should be discarded and replaced by the prudent original cost doctrine, which is subject to accurate accounting treatment.

C.

The Temporary Rates Here Involved Permit More Than a Compensable Return on Prudent Original Cost.

The temporary rate base found proper by the Commission is $5,250,000. This sum is $280,756 in excess of the company estimate of undepreciated original cost of $4,969,244 (R.791), and more than $650,000 in ex-

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Either you are not telling your stockholders the truth when you say, when you carry it at that valuation and are encouraging them to sell out, or you know something about it, as to how much really more valuable it is. Now, don't you think that the stockholders are entitled to know what the value of its assets are?'

"That is boiled down, a long conversation. I felt quite good when he came in, I felt very small when he went out, and I called the directors together and told them I would like to have a valuation made, a very conservative valuation, of the securities we had.

"Such valuation was made and when the change took place, that was when the Delaware corporation made this increase which has, last year, been reversed. It was never of any particular value to us. It was intended to try to tell the stockholders what we believe was more nearly the value of the securities, which his securities represented.

"Q. Where did this stockholder obtain his idea of the value of the securities?

"A. Well, he had the balance sheets of the company showing we carried the stock at a certain amount and he compared the stock market price of the various securities of the American Water Works outstanding, and the two showed a difference of many tens of millions. I would not dare to say at this time whether it was $30,000,000 or $130,000,000, but a very great disparity.

"Q. Whose opinion was the market value?

"A. Well, the people who buy and sell stock in the street.

cess of the Commission finding of undepreciated original cost of $4,600,000 (R. 23). The Commission, to arrive at a proper original cost, found it necessary to reduce the company estimate by $349,880 representing cost of financing.

The record affirmatively shows by the testimony of company witness Boenning that no cost of financing was experienced. (R. 1063) Cost of financing must be shown to have been actually incurred by the utility claiming allowance therefor. See **Galveston Electric Co. v. City of Galveston,** 258 U. S. 388, 397; **Wabash Valley Electric Co. v. Young,** 287 U. S. 488, 500; **Dayton Power and Light Co. v. Public Utilities Commission of Ohio,** 292 U. S. 290, 310; **Cheltenham and Abington Sewerage Co. v. Public Service Commission,** 122 Pa.

"Q. Then, a revaluation of the assets of the Virginia corporation was made?

* * * * * *

"Q. Well, can you tell whether or not any additional securities were issued by the Delaware corporation in addition to those which had been outstanding by the Virginia corporation?

"A. I do not think so. My recollection is that the entire amount subject to the reappraisal was put into capital surplus.

"Q. Not capitalized at all?

"A. Oh, no. I do not think so. That is the best of my recollection.

"Q. Does that $51,000,000 revaluation still appear on the books of the American Water Works and Electric Company Incorporated?

"A. Fashions have changed and we try to change with the fashions and that in effect—I am not an accountant—but it probably was not done that way. But, in my crude way I would say that item was reversed last year.

"Q. Why?

"A. Because of the change of fashions. We did it innocently, but a great many people suspected some wicked ulterior purpose and there was not any, and the easiest thing to do was to undo it."

Superior Ct. 252. The Commission exclusion of cost of financing was entirely proper.

This adjustment reduced the company original cost estimate to $4,619,364, and the Commission found that, for temporary rate purposes, the original cost of the property was $4,600,000. (R. 23) This finding approximates not only the adjusted company original cost estimate of $4,619,364 (R. 23) and the company book cost figure of $4,578,793, (R. 732) but also the Commission original cost estimate of $4,576,169.73 (R. 23)

No deduction was made in any of the estimates or in the finding of original cost, for donated capital or any part of the cost of the steam generating plant, which plant is partly used in the production of steam sold for steamheating purposes by York Steam Heating Company, an affiliate of appellee, although both deductions would have found support in the record.

To $4,600,000 which may be taken as the prudent undepreciated original cost of the property as of November 30, 1936, for temporary rate purposes, we may add $142,851.07 representing net additions to September 30, 1937 (R. 1038), and $164,000 for working capital, to reach a prudent original cost rate base of $4,906,851.07. The Commission ordered the actual annual revenues of $2,202,328.81 reduced by $435,000, leaving predictable revenues of $1,767,328.81. Deducting allowable operating expenses $1,382,829, which include an allowance for annual depreciation, leaves $384,499.81 available for return. This represents return at the rate of 7.83 per cent on the prudent original cost rate base of

$4,906,851.07. We submit that a return of 7.83 per cent upon prudent original cost plus working capital is far above the line of confiscation, and that, therefore, the injunction restraining the enforcement of the temporary rates involved should be dissolved by this Court.

IV.

THE COMMISSION FINDINGS AS TO RATE BASE, OPERATING EXPENSES, AND RATE OF RETURN, ARE REASONABLE AND PROPER AND SUPPORTED BY COMPETENT EVIDENCE.

A.

Rate Base.

The company claimed before the Commission that the fair value of its property should be $5,500,000. (R. 804) This claim was based on the various company estimates, to which were added allowances for going concern value and working capital in the amounts of $400,000 and $150,000, respectively. (R. 800)

In arriving at the rate base the Commission added $164,000 for working capital to its findings of depreciated reproduction and original cost, and gave due consideration to going concern value, although making no specific allowance therefor.

1. Going Concern Value.

In the light of the testimony of record, the action of the Commission in not making a specific allowance for going concern value was entirely warranted. The

company witness who testified on going concern value gave the Commission no sound basis upon which to make a separate finding relative thereto. Much of his testimony, based on consideration of the historical development of predecessor companies, dealt with lag in earnings, and was predicated upon uncertain facts, unsupported opinion and sheer conjecture. The witness himself stated that his lag calculation produced fantastic figures for going concern value which were far beyond what he considered the company to possess in that respect. **(R. 798)** The recent case of **Railroad Commission of California v. Pacific Gas & Electric Co.,** 302 U. S. 388, is authority for the Commission refusal to make a specific finding upon evidence of that character. The Court there declared (pp. 397, 398):

> "There is no principle of due process which requires the rate making body to base its decision as to value, or anything else, upon conjectural and unsatisfactory estimates. We have had frequent occasion to reject such estimates. * * *"

See also **Galveston Electric Co. v. Galveston,** 258 U. S. 388, 395, 396.

Further, the decisions of this Court do not require a separate allowance for going concern value. The latest expressions to this effect are found in the cases of **St. Joseph Stockyards Co. v. United States,** 298 U. S. 38, 62, 63, 64, and **Denver Union Stock Yards Co. v. United States,** 304 U. S. 470,479.

In the instant case, although the Commission did not make a separate allowance for going concern value, it is obvious that this element is liberally pro-

vided for. In addition to valuation of the property from the standpoint of a going concern, the Commission set a fair value figure of $5,250,000, which is substantially in excess of its findings of depreciated reproduction cost and depreciated original cost, including working capital, in the amounts of $4,901,803 (R. 29) and $4,258,000, (R. 29) respectively.

2. Net Additions to Property Between November 30, 1936, and September 30, 1937.

It may be argued that the failure of the Commission to make allowance for net additions to the company's plant and property, from November 30, 1936 to September 30, 1937, in the amount of $142,851.07 was improper. While it is true that such allowance was not made, confiscation could not possibly result therefrom. To demonstrate this, we draw to the attention of the Court the fact that the Commission did not deduct depreciation accruing during the period November 30, 1936, to September 30, 1937. Had such deduction been made for the period above stated it would have been in approximately the same amount as the net additions to the company's plant, so that the net result as to fair value would not have been affected. This clearly appears when it is noted that the annual depreciation allowed is in the amount of $142,531. (R. 37)

3. Conclusion.

The Court below, while it objected to the Commission's method of finding fair value, took no exception to the **amount** found by the Commission to represent fair value for temporary rate purposes, and made no

fair value finding of its own. The Court below may have intended to affirm the fair value rate base used by the Commission in saying (R. 1133):

> "The final report of the commission and the briefs of the parties contain many analyses and a mass of figures which it is difficult for one not a certified public accountant or technical engineer to understand. Some of the figures may be unimportant, but others are important. The commission found that the rate base or fair value of the company's property for the purpose of prescribing temporary rates is $5,250,000."

It was argued below by the company that the Commission should have given effect to an undepreciated reproduction cost estimate as of May 31, 1937, in the amount of $6,019,832. However, the company not only failed to submit any estimate of depreciation to be substracted from this estimate, but it did not feel required to revise its fair value claim of $5,500,000 based upon 1936 reproduction cost figures. Even as late as the filing of the Bill of Complaint in the Court below the company regarded $5,500,000 as the fair value of the property (R. 45, 57).

Conclusive demonstration of the reasonableness of the Commission action so far as rate base is concerned is given by the fact that the amount available for return under the temporary rates is $384,499.81, representing 6 per cent return on a rate base of $6,408,330.16. The Commission ordered the actual annual revenues of $2,202,328.81 reduced $435,000, leaving predictable revenues of $1,767,328.81. Deducting from $1,767,328.81 the allowable operating revenues of $1,382,829, exclusive of return, leaves $384,499.81 avail-

able for return. As stated, if capitalized, this represents a rate base of $6,408,330.16.

B.

If Reproduction Cost Must Be Considered On the Issue of Confiscation, the Record In This Case Contains Sufficient Evidence, and the Commission Order Evidences Sufficient Consideration, to Sustain the Rates Prescribed by the Commission.

If your Honorable Court does not adopt the principles of rate-making which we have urged are vital to effective Commission regulation, then the further questions arise as to whether or not the record in this case was sufficient, and whether or not the order of the Commission indicates that the prescribed rates fulfill constitutional requirements.

Allowable operating revenues, operating expenses and rate of return are treated elsewhere in this Brief. The principles applying to such matters are the same regardless of rate base. Assuming the Commission findings on those points to be correct, as we believe they are, the question of confiscation depends solely upon what standard of value is adopted in determining the rate base. If the prudent original cost of the property devoted to public use is not the proper standard, then it is respectfully represented that the Commission had other methods which it could justly adopt. The elements for determining fair value are set forth by the Court in **Smyth v. Ames,** supra, and subsequent decisions. One of the elements approved by the Court

is the cost to reproduce the property. The company experts, as well as the Commission experts, in this case presented evidence relating to the present cost to reproduce the property. As in every such case, these estimates vary widely. Nevertheless, the Commission in its order conclusively shows that the temporary rates prescribed produce a return of not less than 6 per cent upon the reproduction cost of the property of appellee.

The company offered reproduction cost estimates of its property, exclusive of working capital and going concern value as of November 30, 1936, amounting to $5,572,434 new and $4,950,609 new less accrued depreciation (R. 629). The company estimate of the reproduction cost new of its property exclusive of overhead costs was as follows:

Steam Generating System	$1,216,963
Transmission System	685,296
Distribution System	1,845,067
Utilization System	280,677
General Property	460,900
Total	$4,488,903

These figures were based upon a physical inventory of the actual units of property in place, to which were applied manufacturer's and dealer's quotations of competitive market prices for like material, together with the prevailing rates in the City of York and vicinity for labor necessary in construction. **The Commission accepted these figures in its finding of the reproduction cost new of the property, and made no deduction whatsoever for consumer donated capital,**

nor for the part of the steam generating plant which a Commission witness testified (R. 184) was not used and useful in the company's electric service.

The company estimated that the overhead costs of reproducing its property new amount to $1,083,231. (R. 1020) This total is itemized in the following tabulation, which shows the amount of each overhead item during construction, and the percentage used to estimate each item.

Item of Overhead Cost	*Amount*	*Percentage*
Organization	$ 67,333	1½
Engineering and Superintendence	202,001	4½
General Officers' and Clerks' Salaries	44,889	1
General Officers' and Clerks' Expenses	33,667	¾
Office Supplies and Expenses	11,222	¼
Law Expenditures	22,445	½
Injuries and Damages	44,889	1
Insurance	22,445	½
Taxes	44,889	1
Interest	298,961	6
Cost of Financing	290,490	5½
Total	$1,083,231	22½

Although the arithmetical sum of the percentages is 22½ per cent the percentages are applied to various subtotals so that the result of the allowances ($1,083,231) represents 24.1 per cent of the undepreciated direct cost. Similar application of the individual percentages to depreciated direct cost subtotals results in

$969,263, representing 24.3 per cent of the depreciated direct cost.

The witness who prepared this estimate for the company testified that these figures **represented solely his judgment, and found no support whatsoever in the books of the company. (R. 675, 676).**

The Commission expert engineering witness, L. C. Bierman, testified that, in his judgment based upon full experience, certain overhead allowances requested by the company were greatly excessive, and that a total overhead allowance representing approximately 18 per cent of the direct cost was reasonable. (R. 223) The percentages applied were as follows: Preliminary and organization expenses, 1½ per cent; administration, legal and taxes 1½ per cent; engineering and supervision 5 per cent; interest during construction 6 per cent; and cost of financing 3 per cent. The total of these percentages is 17 per cent, but cumulative application of the various percentages will give a sum in dollars equivalent to approximately 18 per cent of the direct cost. He stated specifically that the company allowances of 1½ per cent for organization, 5 per cent for engineering and superintendence, and 6 per cent for interest during construction were proper. However, he testified that the company claim of 5 per cent for cost of financing should be rejected and a 3 per cent allowance made for this item (R. 226-228).

After giving due consideration to both of these estimates, the Commission rejected both claims and made an allowance of 19 per cent for overheads, which figure is extremely liberal in the light of the decisions of this

Court and the recent Pennsylvania appellate Court decisions. This allowance is comparable with the company overhead percentages applied to original cost, the arithmetical total of which is 19¼ per cent (R. 681, 682) including 7½ per cent for cost of financing, an increase over the 5½ per cent for this item in the company reproduction cost estimate. Application of the company overhead percentages in a cumulative manner to original cost resulted in a total allowance of $850,175, representing 20.4 per cent of the undepreciated direct original cost.

In the case of **Dayton Power and Light Co. v. Public Utilities Commission of Ohio**, 292 U. S. 290, Mr. Justice Cardozo, in discussing the Ohio Commission disallowance of certain overheads, stated (pp. 309, 310, 311).

> "The appellant complains of the refusal to make allowance for organization or preconstruction costs. There is no evidence that any were incurred, though this of itself is indecisive. Ohio Utilities Co. v. Public Utilities Comm'n, 267 U. S. 359, 362. It is conjectural whether they would be incurred in the hypothetical event of a reproduction of the business, and, if incurred, in what amount. The appellants' position as a member of an affiliated system would have a tendency to reduce such expenses to a minimum. We think the ruling is supported by decisions of this court. Los Angeles Gas and Electric Corp. v. Railroad Commission of California, supra, p. 310; Wabash Valley Electric Co. v. Young, 287 U. S. 488; 500
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> "The appellant complains also of the failure to include the hypothetical expense of financing the business as part of the cost of reproduction.

"Considering the absence of evidence that any such expense had been incurred when the business was established and the uncertainty that it would be incurred if the plant were destroyed and reproduced, we think this item under recent decisions was properly rejected as remote and conjectural. Wabash Valley Electric Co. v. Young, supra, p. 500; Los Angeles Gas and Electric Corp. v. Railroad Commission of California, supra, p. 310. We are to remember that the cost of reproduction is a guide, but not a measure. Los Angeles Gas and Electric Corp. v. Railroad Commission of California, supra, p. 307.

"What has been said of the foregoing items applies with little variation to the reduction of 'general overheads' or undistributed expenses during the period of construction, from 17%, the amount claimed by the appellant, to 14%, the amount allowed by the Commission."

Upon the authority of the Dayton Power and Light case and the cases cited therein, it is apparent that the Commission in the instant case might, with perfect propriety, have further reduced the allowances for organization and cost of financing since the company is a member of the Associated Gas and Electric Company affiliated system, a fact which "would have a tendency to reduce such expenses to a minimum," or it might have eliminated them entirely, since no proof shows them actually experienced.

The company submitted an estimate in the amount of $4,950,609 of the depreciated reproduction cost of its property, including overhead items (R. 629), claiming that accrued depreciation was equal to 11 per cent of reproduction cost new. Engineering inspection

to determine the present condition of the various units of company property formed the basis of this estimate, **and the commission accepted the figure of 11 per cent for accrued depreciation in making its finding of depreciated reproduction cost.**

Using the company estimate of **direct** costs depreciated ($3,981,347) and 19 per cent thereof for reasonable overhead allowances ($756,456) the Commission found that the depreciated reproduction cost of the property was $4,737,803. (R. 21) The Commission rate base of $5,250,000 is thus $512,197 in excess of depreciated reproduction cost.

C.

The Commission Findings As To Operating Expenses Are Reasonable and Proper.

The Commission found that annual operating expenses of $1,382,829 were properly allowable. This amount includes allowances for operation and maintenance expenses, taxes, and annual depreciation, but excludes the rate of return allowance of $315,000.

The Commission allowed operating and maintenance expenses in the amount of $1,033,898, substantially based upon the actual operating results for the year ended September 30, 1937, as reflected by company Exhibit No. 23, (R. 1038A) a summary of which appears below:

	Net Charges
Production System	$ 37,905
Electricity Purchased	602,846
Transmission System	9,670

Distribution System	73,635
Utilization System	15,409
Commercial Department	64,673
New Business Department	50,927
General Administrative	78,931
Other General Expenses	185,230
	$1,119,226

Although the record contained substantial evidence that certain of the above amounts were questionable, **the Commission, for the purpose of temporary rates, allowed them all except the one charged to "Other General Expenses."** That amount was adjusted to eliminate the sum of $127,935 representing expenses incurred in connection with the instant rate case. The Court below held that the Commission elimination of these expenses, together with other similar expenses later incurred, was improper. The total of rate case expenses finally eliminated was $178,374.50.

1. Rate Case Expenses.

The questions of whether or not a regulatory body must allow rate case expenses incurred in a proceeding decided adversely to the utility, and whether or not such expenses may be considered by the Courts in determining the matter of confiscation have not been decided by this Court.

(a) Where a Rate Decision Is Adverse To a Utility, Rate Case Expenses Need Not Be Allowed.

The rule that the utility must bear the cost of rate litigation if it does not prevail has been uniformly

followed by the Pennsylvania Courts. **Scranton-Spring Brook Water Service Co. v. Public Service Commission,** 119 Pa. Superior Ct. 117, 144; **Scranton-Spring Brook Water Service Company v. Public Service Commission,** 105 Pa. Superior Ct. 203, 227; **City of York v. Public Service Commission,** 85 Pa. Superior Ct. 139, 141, 142. Since this rule is rooted in substantial consideration of the public interest, we respectfully urge that this Court enunciate it as the law of this case.

In **Wabash Valley Electric Co. v. Young,** 287 U. S. 488, the Commission and the Federal Court below refused to allow rate case expenses in the amount claimed by the utility, and this Court held that such refusal was proper. The question decided was not whether a duty existed to make an allowance for rate case expenses, but whether the allowance as made was unreasonable. Further, the utility did not contend that disallowance of a portion of its claim resulted in confiscation, but argued that such action was arbitrary and without basis in the evidence. It is obvious that the questions involved in the instant case were not presented in the Wabash Valley Electric Company case, and consequently that case is not controlling here.

This Court again dealt with the matter of rate case expenses in **West Ohio Gas Co. v. Public Utilities Commission of Ohio (No. 1),** 294 U. S. 63. There the Ohio Commission found that rates imposed upon the utility by municipal ordinance were confiscatory, and it fixed new rates to take effect retroactively without

making an allowance in operating expenses for the expense incurred by the company in prosecuting its complaint against the ordinance. The Supreme Court of Ohio affirmed the order of the Commission, but, on appeal, this Court reversed, deciding, inter alia, that the rate case expenses claimed by the company should have been allowed. This case is cited by the Court below as authority for the conclusion that the Commission action here was improper. However, analysis shows it to be clearly distinguishable. In the West Ohio Gas Company case, the expenses were incurred in opposing rates not promulgated by the company, and the question of confiscation was decided in the company's favor. In the instant case, the expenses were incurred in defending rates initiated by the company, and these rates were found to be excessive. Furthermore, appellee presented testimony showing that it had offered an annual reduction of $250,000 to the Commission, and that after such reduction it would still earn sufficient revenue (R. 775, 777). These differences, we submit, are fundamental, and therefore the principles expressed in the West Ohio Gas Company case are not applicable here. It is entirely proper that the public be required to bear the expense of defending the utility against oppressive municipal action, but it is unconscionable to call upon the consumers to pay expenses directly attributable to the unjust and unreasonable action of the company. Mr. Justice Cardozo, in his opinion in the West Ohio Gas Company case, recognized these distinctions by stating (294 U. S. 63, 73):

> "A different case would be here if the company's complaint had been unfounded, or if the cost of

the proceeding had been swollen by untenable objections."

Complainant is admittedly receiving a return greatly in excess of its own claimed return on its own claimed fair value (R. 777, 804), and offered to reduce its rates $250,000 per year if the Commission would drop the proceeding (R. 774, 775, 778). In the light of these admissions, it is obvious that the case cannot possibly result favorably to complainant, and that therefore the consumers should not be required to pay rate case expenses incurred with full knowledge of the fact that the rates defended were far too high and, in fact and law, indefensible. The unfairness of burdening consumers with rate case expenses here is even more obvious when we consider the fact that complainant has not given its consumers even the benefit of the $250,000 reduction to which they were admittedly entitled. This admission was made on the record March 11, 1937 (R. 775, 777), but not one penny of the offered reduction has been made available to the consumers of York and vicinity. Today, those consumers are paying rates which are admittedly at least a quarter of a million dollars annually in excess of reasonable rates.

(b) Rate Case Expenses Are Irrelevant to the Issue of Confiscation.

This Court has not decided whether or not a lower Court, in determining the validity of rates fixed by a Commission in substitution for those established by a utility, may base a finding of confiscation on Commission disallowance of rate case expenses.

We submit that the Court below in the instant case erred in so doing.

The West Ohio Gas Company case held that it was the duty of the Commission to allow rate case expenses **after the utility had established confiscation,** but it did not decide that, in initially determining the question of confiscation, such expenses could be considered. On the contrary, the Court points out that in the view of a substantial number of lower Federal Courts **rate case expense allowance should have no bearing when the issue of confiscation is initially decided,** because (294 U. S. 63, 74):

> "If the rates are inadequate to the point of confiscation, the complainant has no need, it is said, to count upon the expenses of the lawsuit; if they are not already inadequate, the lawsuit cannot make them so. Cf. Columbus Gas & Fuel Co. v. City of Columbus, 17 F. (2d) 630, 640."

The District Court, in the Columbus Gas and Fuel Co. case cited in the above quotation, was of opinion that allowing the utility's cost of preparing and prosecuting its claim of confiscation directly to produce or influence the finding on the issue of confiscation would be unreasonable and inequitable, and with this position appellants are in entire agreement.

As said by Mr. Justice Reed, in **Petroleum Exploration, Inc. v. Public Service Commission of Kentucky,** 304 U. S. 209, 222, discussing the "irrecoverable expense" of preparing for a Commission hearing, "the expense and annoyance of litigation is 'part of the social burden of living under government.'"

To give weight to rate case expenses in a proceeding to determine the issue of confiscation would, in effect, allow a utility, by the inflation of rate case expenses, to overcome a non-confiscatory rate, and would put a premium on prolonged and expensive rate litigation. Such a rule would inevitably result in defeating proper regulation.

2. Non Experienced Operating Expenses

The company offered testimony upon certain items of operating expense which it claimed would in the future be incurred in addition to the experienced items above tabulated. These items are as follows:

1. Rental of Property owned by York Railways Company but used by Edison Light and Power Company	$18,000
2. Payroll increases made effective during 1937	13,488
3. Pension cost	5,819
4. Proportion of annual salaries of common administrative personnel of respondent and affiliates paid by respondent and reflected on annual basis	20,593
5. Estimate for rate case expense of Commission and regulatory expense to be assessed by Commission under Section 1201 of the Public Utility Law	21,792
Total additional claims, per annum,	$79,692

The first three of the above items were allowed by the Commission for the purpose of temporary rates. The fourth item, in the amount of $20,593, was properly disallowed by the Commission, and the reason therefor is best expressed in the words of the order as follows:

"The fourth item, amounting to $20,593, results from a new policy on the part of respondent regarding services rendered by its officers and employees to affiliated companies. By resolution adopted October 28, 1937, the Board of Directors of respondent company provided that the company should 'pay in full the present salaries of all its officers and employees without charging or allocating any part thereof to any affiliated company.' The resolution also provided that 'as rapidly as feasible' the existing practice of having employees of respondent render services to affiliated companies should be discontinued. It is our opinion that the amount claimed as additional expenses, namely, $20,593, due to the change of policy, should be disallowed at this time. It appears that the various companies will continue to have their offices at the same location or headquarters, under the management and supervision of the same personnel."

"Respondent, in assuming these additional operating expenses, is or may be relieving its less prosperous affiliated companies of their fair share of the cost of administering and conducting the general office which is now and has been occupied and operated during many years, for their mutual benefit. The resolution of respondent's Board of Directors is vague and indefinite as to the time when the change is to become effective, and we are of opinion that, until the change is actually consummated and its reasonableness demonstrated, the resulting increase in expenses should not be reflected in rates." (R. 34, 35).

The Court below was of opinion that this item should have been allowed because the evidence does not show it to be unreasonable and exorbitant, and stated that Commission rejection of it amounted to an attempt to

manage the company We believe that a mere reading of the above quoted portion of the Commission order, bearing in mind the fact that the company has the burden of proof, will serve to demonstrate the Court's error.

The fifth item, in the amount of $21,792 was properly disallowed and the company claim adjusted for the reasons stated in the Commission's order (R. 35). The Court below took no exception to this action of the Commission.

3. Allowance Claimed for Conjectural Loss of Business.

The company, in objecting to the Commission finding of allowable operating revenues, claimed that the Commission should have made an allowance in the amount of $15,089 for the loss of such revenues as will result from the abandonment of railway service by York Railways Company (hereinafter referred to as Railways), an affiliate which purchases power from the company. The Court below held that this allowance should have been made and, as the sole reason therefor, stated (R. 1134):

> "As we understand it, the abandonment is certain and is not denied."

At the time of the order in this case, although such abandonment was contemplated, Railways was in operation, and the Commission had no means of determining the certainty or the date of abandonment. At the time when the decision was rendered by the Court below, Railways was still operating, under the juris-

diction of the United States District Court for the Eastern District of Pennsylvania under the provisions of Section 77B of the Bankruptcy Act as amended. There is consequently nothing of record to support the Court's statement.

In addition to the absence of proof of actual abandonment, there is further support for Commission disallowance of this item. That is found in the fact that **the record contains no substantial evidence tending to show that loss would result from abandonment of service by Railways.** Company Exhibit No. 7 purports to show that the sale of power to Railways results in $15,089 profit. **(R. 1018)** An analysis of the exhibit reveals the fallacy therein. The company shows that it purchased a total of 71,151,000 KWH in 1936 at a cost of .771 cents per KWH. It sold 4,232,300 KWH to Railways at .900 cents per KWH. Due to the size of its total purchase, the company was able to obtain a block price for 4,232,300 KWH at .610 cents per KWH. The company therefore concluded that the profit per KWH from the sale of power to Railways should be calculated as the difference between .900 cents and .610 cents rather than the difference between .900 cents and .771 cents. This is palpably erroneous. **It is obvious that the company has no more right to claim that Railway's purchase is responsible for the lowest block price the company must pay for power than are the purchases of any of its other consumers.** The correct method to employ in estimating the profit attributable to Railways purchases would have been for the company to deduct from the price of .900 cents per KWH paid by Railways the average

cost price of power to the company of .771 cents. If this had been done the company's apparent profit figure would be $8,266.97 instead of $15,089. This apparent profit of $8,266.97 gives consideration to all of the elements set forth in company Exhibit No. 7, including maintenance of conversion equipment and corrective effect of Railway's load on system power factor.

The record further disclosed that the company renders its service to Railways over facilities used exclusively to serve the latter (R. 184). It is evident that, in estimating the company's cost of serving Railways, the carrying charges of these facilities must be included. As submitted in the testimony of the Commission engineering witness, H. Root Palmer, the annual carrying charge on these facilities is $8,465.10 (R. 202, 203). Operating and maintenance expense and insurance costs on the facilities are also borne by appellee (R. 203). When these costs are considered the so-called profit is shown to be a loss.

In addition to the foregoing, we desire to point out that, since the sale of power by the company to Railways is a transaction between affiliates, it is subject to the closest scrutiny, and that before the Commission could find that such sale resulted in profit to the company it must have evidence of the most convincing character. This Court in **American Tel. & Tel. Co. v. United States,** 299 U. S. 232 said, concerning transactions between affiliates (p. 239):

> "There is widespread belief that transfers between affiliates or subsidiaries complicate the task of rate making for regulatory commissions, and impede the search for truth. Buyer and seller

in such circumstances may not be dealing at arm's length, and the price agreed upon between them may be a poor criterion of value. Dayton Power and Light Co. v. Public Utilities Comm'n of Ohio, 292 U. S. 290, 295; Western Distributing Co. v. Public Service Comm'n of Kansas, 285 U. S. 119; Smith v. Illinois Bell Telephone Co., 282 U. S. 133."

It is submitted that the evidence of the company in support of the allowance here in question is of the most dubious and unsatisfactory nature and, had the Commission made such allowance, it would have, in effect, given the company a bonus to which it is not entitled.

Since there is neither proof of actual abandonment by Railways and consequent loss to the company, nor substantial proof of prospective abandonment and strong likelihood of loss, we earnestly represent that the holding of the Court below is wholly unsupported and palpably error.

4. Taxes.

The company's estimated tax liability for the twelve months ended September 30, 1937, was in the amount of $333,649, and the Commission in making its allowance of $206,400 for taxes adjusted the former figure to conform with the $435,000 reduction ordered in the company's gross annual revenues. The Court below made no finding as to the reasonableness of the Commission's allowance, but stated in its opinion:

"The other item in dispute grows out of the adjustment of taxes because of the reduction in

> revenue of $435,000 ordered by the commission. The original amount of taxes paid by the company was $333,649 and the commission allowed a reduction of $127,249 leaving a balance of $206,400 to be paid by the company. The company, on the other hand, says that $148,455 should have been allowed, leaving a balance of $185,194 to be paid. It is not clear just how this difference of $21,206 between them arose, but it does not have a decisive bearing on the case, for the reason that if the contention of the company is correct, it decreases the expense, increases the profit and the rate of return." (R. 1134, 1135)

The Court below erred in stating that the difference between the Commission and the company on the matter of taxes had no decisive bearing on the case. If the company's contention is correct, then it is clear that the company has been allowed $21,206 more than it is entitled to on this account and this must be taken into consideration in determining whether the Commission order **in the totality of its consequences** is confiscatory. That the Court below failed utterly to consider this is apparent from its own words.

D.

Rate of Return.

The Commission, for temporary rate purposes, allowed the company a 6% rate of return. The Court below did not make a finding of fair rate of return, and did not disturb the Commission finding.

In the hearings before the Commission, the company evidence on rate of return consisted solely of the

testimony of T. E. Seelye. This witness stated that in his opinion 7½ per cent was a fair rate of return, and he explained that **this figure was based on the customary 6 per cent allowance, to which was added 1½ per cent calculated to compensate the company for any loss which it might sustain in the event that its affiliate, York Railways Company, discontinued service. (R. 885, 886)** Obviously a rate of return estimate based only upon these considerations is utterly worthless. Problematical loss or expense from abandonment by York Railways Company or other contingencies is admittedly a matter to be considered in connection with operating expenses, **(R. 885)** and cannot be considered in computing a reasonable rate of return. That the witness's 7½ per cent figure was not influenced by prevalent money rates or corporate earnings is undeniable, since he admitted that he made no studies on the subject. **(R. 886)**

At the hearing held before the Court below on January 17, 1938, the company offered as witnesses H. D. Boenning, an investment banker, and G. K. Knutson, a financial consultant, both of whom testified that in their judgment the company was entitled to an 8% rate of return. These estimates were based on studies of the company's balance sheets, its statement of earnings for the years 1935, 1936, 1937, and the various estimates of cost and revenue prepared by the company engineers. No investigation of conditions in the company territory was made. No statistical studies or examples whatsoever were given to support the witnesses' opinions. We submit that, since all of this testimony is based purely upon either speculation or upon information submitted by the company without

any semblance of independent checkup on the part of the witnesses, it has no probative value.

On the other hand, the Commission testimony on rate of return is of a very substantial character. We refer the Court to the testimony of R. A. McShea, Jr., Commission accounting expert (R. 966-977), relating to his exhaustive studies of money rates, yields on corporate securities, corporation earnings, etc. and to Commission Exhibits 32 to 36 inclusive (R. 1004-1013), which contain the details thereof. Mr. McShea stated (R. 851), that Commission Exhibit 32, sheets 1 and 2 (R. 1004, 1005) show generally that the trend of yields for all issues covered by the exhibit, which, incidentally, were reported by disinterested financial service organizations, were generally lower in the years 1934, 1935 and 1936 than at any time back to 1913. Likewise, the bond yields appearing on sheet 3 of Commission Exhibit No. 32 show that for 120 issues, including 40 public utility issues, rates of return were lower in 1935, 1936, and early 1937 than in the three years from 1932 to 1934 inclusive. Commission Exhibit 33 (R. 1007) shows the current yields on the securities of Pennsylvania Utilities; Commission Exhibit 34 (R. 1008) the yield on bonds and preferred stocks of Pennsylvania Electric Utilities; Commission Exhibit 35 (R. 1012) New York Money Rates; and Commission Exhibit 36 (R. 1013) corporation profits for 574 corporations selected at random. In addition, Mr. McShea testified (R. 972) as to the rates of interest paid on savings accounts in the City of York during the past ten years.

This Court has many times stated that rate of return is a matter for determination upon the individual factors of each specific case, and that no formula can be prescribed therefor. The controlling factors which must be considered by regulatory bodies in arriving at fair rate of return have been set forth in decisions so numerous that restatement of them here is unnecessary. [4]

We submit that these factors have been carefully weighed by the Commission and that, under all the circumstances, considering the established character of the company's business, the prosperous community served, the company's financial stability as evidenced by its several decades of fabulous earnings (undiminished in depression years), and presently existing conditions respecting money rates and corporate yields, a rate of return of 6 per cent in this case cannot possibly be confiscatory.

We, therefore, submit that the findings of the Commission, relative to rate base, operating expenses, and rate of return, are reasonable and proper and fully supported by substantial competent evidence.

CONCLUSION

In conclusion, the Commission urges that this Court rule:

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[4] Knoxville v. Knoxville Water Co. 212 U. S. 1, 17, 18; Willcox v. Consolidated Gas Co. 212 U. S. 19, 48-50; Bluefield Water Co. v. Pub Serv. Comm. 262 U. S. 679, 692; Lindheimer v. Illinois Tel. Co. 292 U. S. 151, 175; Dayton Power & Light Co. v Utilities Comm. 292 U. S. 290, 311, 312; United Railways v. West 280 U. S. 234, 249, 250, 251; St. Joseph Stock Yards Co. v. United States, 298 U. S. 38, 72.

1. That temporary rates are desirable for effective rate regulation. It is constitutionally proper for a Commission, in the course of a rate investigation, to prescribe temporary rates pending full consideration of matters in substantial dispute.

2. That Section 310 of the Pennsylvania Public Utility Law is constitutional. It provides an adequate method for recoupment of loss, if any, while temporary rates are in effect, and thereby prevents confiscation. Furthermore, it does not restrict the Commission as to the elements of value it may consider, but authorizes the presciption of just and reasonable temporary rates, consistent with constitutional standards.

3. That rates affording a public utility a fair return upon the prudent original cost of its property used or useful in public service are not confiscatory.

4. That, on the entire record, the order of the Commission is just and reasonable. The Commission findings as to rate base, operating expenses, depreciation, and rate of return are reasonable, proper and supported by the evidence, and, therefore, the rates prescribed are not violative of constitutional prohibitions.

5. That the injunction restraining the enforcement of the Commission order was an unwarranted interference with the legislative process of rate making, and should be dissolved.

Respectfully submitted,

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